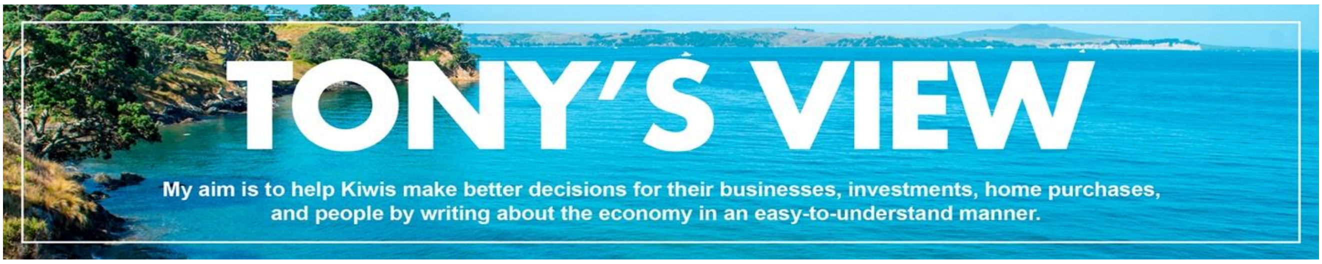

Input to your Strategy for Adapting to Challenges

Feel free to pass on to friends and clients wanting independent economic commentary

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Excuses for errors

I've been mentioning recently my main theme of the Reserve Bank over-restricting the economy and a rapid series of rate cuts eventually coming somewhere down the track. But we are nowhere near that point as yet and inflation for the moment is still a problem.

My other main theme has been running since late-2022 and it is that you should not develop strategies which are strongly dependent upon a particular set of forecasts or expectations proving accurate. The predictions will be wrong and the thing we people in this business primarily aim to do is quickly recognise when we are off-track and adjust our outlook accordingly.

A couple of months ago we saw an example of that going wrong via a prediction of extra monetary policy tightening which freshly spooked the housing market. In a way what happened is consistent with a view that we will continue to see shocks affect the outlook and you need to be able to adapt to these things when they come along.

All through 2023 in my various presentations around the country, before I got into what I thought the outlook was for NZ I would spend considerable time outlining various reasons why predictions would be wrong. And in doing so I'd emphasis that I was not just talking about forecasts made by us economists but all the predictions being made by people in their businesses.

Cash flow projections, workflow expectations, likely changes in asset prices and so on. I would couch things in terms of giving attendees a list of reasons they should note down because in 18 months time when their boss, board, or spouse would be ragging on them for getting things wrong, you'd want to pull the list out. You'd want to show them why it was never reasonable to expect that things would turn out as anyone expected back then.

That remains the case now. We continue to live through a minimally predictable environment and you should not seek certainty when planning your business, investment, and personal strategies. A key example recently of the way things are not turning out as expected is the upside surprise to the pace of growth in the United States economy.

The surprising strength has led to a substantial decline in expectations for the timing and then speed with which monetary policy will be eased over there. That has pushed their wholesale interest rates higher with upward pressure on our rates also happening. These local rate rises have stripped away the above average margins which banks in recent months have been running for all bar their one-year fixed mortgage rates. Scope for “natural” cuts in fixed mortgage rates has all but disappeared.

For your guide, here is a list of some of the factors which make predictability poor in our current environment. There are many more factors than I am showing here but these should suffice to encourage you to exercise caution regarding putting your family home or retirement on the line on the basis of your favoured scenario playing out.

Pandemic uniqueness

The extremely negative and incorrect predictions for economic growth, unemployment, house prices etc. made when the pandemic struck in 2020 reflected the fact we had no experience of what usually happens when a global pandemic strikes. Now, we are in a similar unique situation. None of us knows what usually happens when a global pandemic ends and border restrictions are removed along with domestic constraints on activity.

Forecasts for instance of the strength in China’s economy following their opening up over a year ago quickly proved very wrong. We don’t know when China’s householders will truly come back out of their shells and that is relevant to the likely strength in prices for our key commodity exports given our dependence on buying out of China.

Excess stimulus

The models which central banks etc. run have been estimated over periods of time when monetary policies have been loosened and tightened and the same for fiscal policies along with shocks etc. But we do not have a previous period in New Zealand of both monetary and fiscal policy being massively eased together for too long a period of time. That means we can only guess at the track which inflation in particular will take to get back into the 1% - 3% range.

Low unemployment

Businesses learnt quickly in the second half of 2020 that the unemployment rate was not going to shoot up to 8% from 4% pre-pandemic. Those businesses which had laid off staff scrambled to find them again – without success in some cases.

The excess stimulus applied to the economy caused the unemployment rate to fall to just 3.2% and the pace of wages growth to exceed 7.5%. To what extent will the memories of ongoing labour shortages and soaring labour costs from 2020 – 2023 cause businesses to continue to hoard labour even though our economy is in recession?

The lesson from both the United States and Australia is that labour market strength post-pandemic is turning out to be a lot greater than expected despite tight monetary policy. This has implications for the speed with which wages growth slows down and therefore the easing of inflation and eventually interest rates.

Honestly – we don't have the foggiest idea of when wages growth will slow enough for the Reserve Bank to seriously ease monetary policy. There is no previous period we can look to and say that gives us strong insight.

Record net immigration

What usually happens when net migration flows boost our population by 2.5% and the overall population growth rate hits the fastest pace since 1947? And, what happens when these flows include a net loss of Kiwi citizens of 48,000 people offset by generally low skilled foreigners coming in?

We don't know. We can theorise that there will be upward pressure on rents and we can see that coming through in the various datasets. We can theorise that there will be downward pressure on the pace of wages growth. How much? Don't know.

Again, this is relevant to the speed with which interest rates eventually come down and house prices go up.

Construction weeding out

A lot of inexperienced, under-capitalised, over-optimistic people rode the boom in house construction upward over 2020-23. Now many are being weeded out as presales are hard to achieve, bank finance is tight, costs have soared, and interest rates are high.

How many get weeded out is anyone's guess but experience shows us that just as the upward leg of the house construction cycle spreads far and wide across many businesses, so too does the downward leg which will run through to late-2025 it increasingly appears.

Cost of living shock

It is a long time since we saw a sustained high rate of inflation in New Zealand - which is the same thing as saying a sustained high pace of increase in the average household cost of living. We can't be sure how people without experience of such times will alter their spending in magnitude and direction.

Will they mainly curtail discretionary spending, durables, luxuries, or just savings?

No exchange rate shock

What does it mean when you have a rapid tightening of monetary policy which does not involve a rapidly appreciating NZ dollar? In the past the NZD has tended to jump when interest rates rise here and a lot of the restraint pain gets borne by the export and import-competing sectors. But that is not a policy transmission mechanism which is in play this time around and that means extra restraint on spending has to come from high debt servicing costs.

This is unusual and creates extra uncertainty while sparing exporters their traditional pain.

Other factors

Consider these factors already mentioned. Now, try and figure out what the impact will be on the things which interest you of other factors such as the following.

- Possible election of Donald Trump as US President later this year.
- China's expansion of influence beyond its land borders and pushback by other countries.
- Artificial intelligence
- War in the Middle East
- War in eastern Europe
- Unwinding of some restrictions on activities in the New Zealand economy by the new coalition government.
- Climate change

Good luck.

In case you missed it

The survey I run each month of mortgage brokers with sponsorship from mortgages.co.nz showed the following key things.

- Buyer interest in residential property remains but it has eased slightly recently.
- Bit by bit banks are slowly easing their lending criteria.
- Borrowers overwhelmingly only want to fix their interest rate for a period of one year or less.

mortgages.co.nz & Tony Alexander Mortgage Advisers Survey - April 2024 - mortgages.co.nz

My monthly survey of businesses undertaken with sponsorship from Mint Design yielded 252 responses and the following main insights.

- Businesses have grown more concerned about the state of the economy. This has implications for their plans to hire people, maintain existing staff numbers, and undertake new capital expenditure and perhaps market expansion strategies.
- Businesses are cutting spending on recruitment and expect staff morale to decline. But they do not plan spending more on workplace culture. If there is an assumption that the culture will be unaffected by labour market deterioration this could

represent a blindspot for businesses of high relevance to staff retention when the labour market picks up again.

- A notable difference between this monetary policy tightening cycle and those of the past is the absence of a rapid and large appreciation of the NZ dollar. For the entirety of our survey timeline respondents have rated a high NZD as one of their smallest concerns.

Mint Business Insights - April 2024 - Mint Design

If I were a borrower, what would I do?

Wholesale rates have barely budged this week.

The markets await extra insight into whether expectations of an easing later this year are justified.

If I were borrowing at the moment I would take a mix of 6 and 12 month fixed rates and expect to make a similar decision in 6-12 months time.

Nothing I write here or anywhere else in this publication is intended to be personal advice. You should discuss your financing options with a professional.